DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

FEB - 3 2006

The Honorable Wally Herger
U.S. House of Representatives
Washington, DC 20515-0502

Dear Mr. Herger:

I am responding to your letter dated December 13, 2005, in which you raise several questions about the treatment of cash awards received by plaintiffs ("taxpayers") in a settlement of an inverse condemnation proceeding under the name *Paterno v. State of California*. Your letter raises the following questions: (1) whether the portion of the award designated as prejudgment interest should be treated as ordinary income by the taxpayers, and not as part of the amount realized from the inverse condemnation of property; (2) whether attorneys' fees paid or incurred by the taxpayers are deductible expenses or are nondeductible capital expenditures; (3) under what circumstances may the taxpayers take a casualty loss deduction for destroyed property; (4) what efforts the IRS has made to inform the taxpayers of their potential tax liability in this matter; and (5) whether the receipt of Forms 1099-Miscellaneous that report the amount of the cash awards will result in the selection of the taxpayers' tax returns for audit.

I. Interest

You indicate that the settlement reached by the parties in the *Paterno* litigation included a payment to the taxpayers of prejudgment interest. You ask whether the interest constitutes ordinary income to the taxpayers. California law allows prejudgment interest in inverse condemnation actions. *See* Cal. [Civ. Proc.] Code §1268.310 (West 2006); *People v. Gardella Square*, 246 Cal. Rptr. 139 (Cal. Ct. App. 1988). Generally, interest awarded in a condemnation suit is compensation for the delay in payment and is not part of the damages awarded for the converted property. *Kieselbach v. Commissioner*, 317 U.S. 399, 403-404 (1943). A taxpayer generally must include the interest portion of a condemnation award in gross income as ordinary income. *See* section 61(a) (4) of the Code and section 1.61-7(a) of the Income Tax Regulations. Therefore, the prejudgment interest portion of the settlement is taxable as ordinary income to the taxpayers, and is not part of the property recovery.

II. Attorneys' Fees

You ask whether the attorneys' fees paid or incurred by the taxpayers are deductible expenses or instead are nondeductible capital expenditures. The tax treatment of attorneys' fees is determined by analyzing the origin of the claim with respect to which the attorneys' fees were incurred. Where the claim originates in a capital transaction, such as the acquisition, disposition, or recovery of a capital asset, the attorneys' fees are capital expenditures. *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970); *Woodward v. Commissioner*, 397 U.S. 572 (1970). On the other hand, claims that originate in a suit to collect ordinary income may give rise to deductible attorneys' fees. In many cases, a lawsuit seeks to recover both capital and ordinary items, and some allocation of attorneys' fees between the capital and ordinary claims is necessary.

The *Paterno* litigation has its origin in the recovery of a capital asset. Although the taxpayers also received prejudgment interest that is taxed as ordinary income, prejudgment interest is awarded automatically under California law to successful plaintiffs in inverse condemnation proceedings. That is, no separate proceeding is required to obtain prejudgment interest. Also, there is no indication in your correspondence that attorney time was spent on the determination of prejudgment interest. In the absence of a separate prejudgment interest proceeding or a specific allocation of attorney time, it is reasonable to assume that all attorneys' fees are allocable to the capital recovery, and therefore are nondeductible capital expenditures.

III. Casualty Loss Deduction

Under section 165(a) of the Internal Revenue Code, a taxpayer may take a casualty loss deduction for any loss sustained during the taxable year not compensated for by insurance or otherwise. Losses due to flooding are generally deductible casualty losses. See Rev. Rul. 76-134, 1976-1 C.B. 54, and Rev. Rul. 63-232, 1963-2 C.B. 97. The Code treats business and personal casualty losses differently. If an individual incurs casualty losses in a trade or business or in a transaction entered into for profit, the casualty losses may be deducted without limitation. *See* section 165(c) of the Code. However, deductions for a personal casualty loss are subject to the limitations in Section 165(h) of the Code. Because casualty loss issues depend heavily on a taxpayer's particular facts, it is difficult to generalize on this subject. Taxpayers may find answers to their specific casualty loss questions in Publication 547, *Casualties, Disasters, and Thefts* (copy enclosed).

IV. Outreach Efforts

Finally, you note that tax preparers in Yuba County have made several outreach efforts, and you ask about IRS outreach efforts. Bob Meyer, a Sacramento Territory Manager, participated in two Town Hall Meetings sponsored by the California Society of Enrolled Agents in August 2005. Mr. Meyer is available to participate in future outreach efforts at your request. You may reach him at (916) 974-5471 or by email at Bob.Meyer@irs.gov.

V. Form 1099 Concerns

You also ask whether receipt of Forms 1099-Miscellaneous by the taxpayers will result in the IRS's computers erroneously identifying the taxpayers as not having reported their taxes correctly. As discussed by telephone with your staff, we will reply to this question by separate letter.

I hope this response is helpful. If you need further information, please contact Sara Shepherd, Identification Number 50-11377, at (202) 622-4960.

Sincerely,

Marie Noce for

Donald L. Korb
Chief Counsel

Enclosure